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Fortifying NBFCs

Proposed RBI guidelines on Liquidity Risk Management

pwc

Need for liquidity risk guidelines

Non-banking financial companies (NBFCs) in India hold a significantly large portfolio. Their smooth functioning is essential for the growth and development of the Indian economy. In recent times, NBFCs have been found to be constantly facing problems with managing their liquidity positions owing to multiple factors such as increase in borrowing costs, asset -liability mismatches, repricing risks, nature of assets and reluctance of lenders/investors. Hence, considering the balance sheet size and importance of NBFCs to the Indian economy, the regulatory authority has decided that it is vital that NBFCs be made more resilient, well-regulated and properly governed in terms of liquidity risk vis-à-vis management of their assets and liabilities.

On 24 May 2019, the Reserve Bank of India (RBI) published draft guidelines on 'Liquidity Risk Management Framework for Non-Banking Financial Companies (NBFCs) and Core Investment Companies (CICs)',[1] which are to be adopted by all deposit-taking NBFCs, non-deposit taking NBFCs with an asset size of INR 100 crore and above, and all CICs registered with the Reserve Bank.

The circular at a glance

While the RBI has restated some of the guidelines currently applicable to NBFCs on the assets and liabilities management (ALM) framework, some new features have been added to the overall approach. The circular primarily acts as a guidance document towards developing a comprehensive Liquidity Risk Management (LRM) framework for NBFCs and focuses on the areas shown below.

- LRM policy, strategies and practices
- Management information system
- Internal controls
- Maturity profiling
- Measurement – stock approach
- Currency risk
- Managing interest rate risk
- Liquidity risk monitoring tools

1 https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=3678

Key parameters of the LRM framework and our views

Implementation of the guidelines and the development of a sound LRM framework in NBFCs is a cumbersome activity and will require the companies to make a significant effort. They will have to work with the regulators to adopt these standards in a phased manner in order to ensure that their operations are hampered only marginally and earnings remain stable. This is possible if NBFCs focus on the aspects mentioned below.

Governance

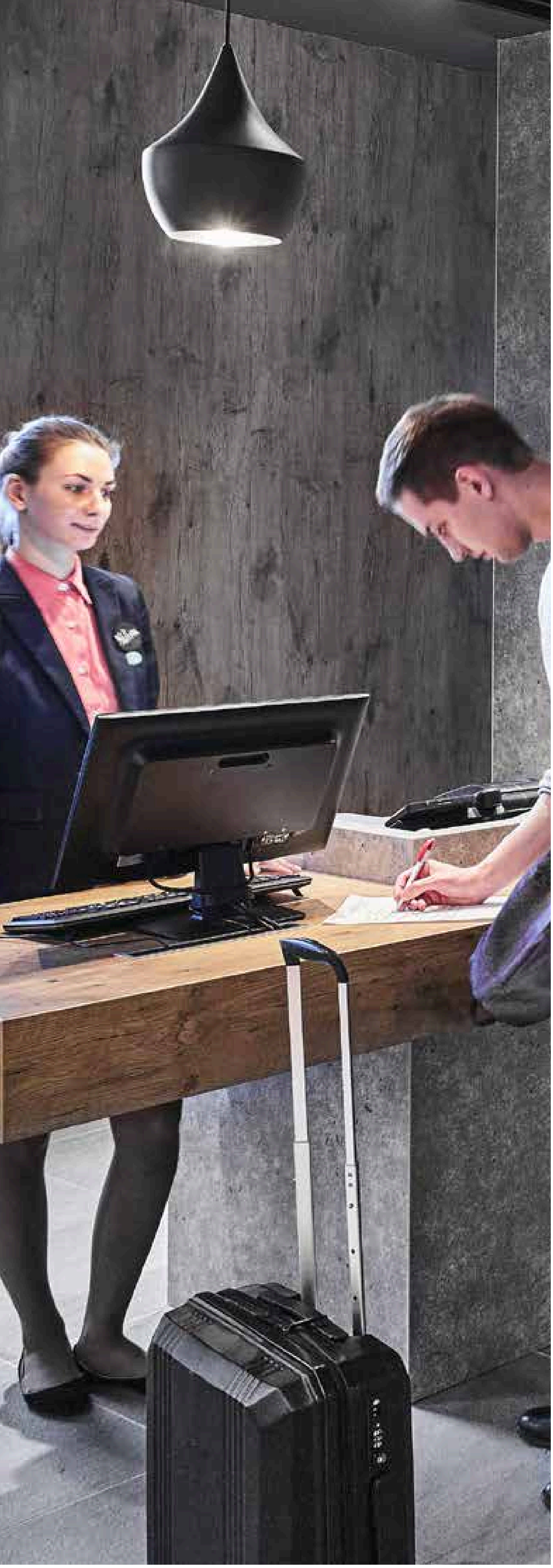
Appropriate governance is imperative for the implementation of a sound LRM framework in NBFCs. In order to integrate the day-to-day operational aspects and strategic decisions with LRM, a comprehensive governance structure is necessary.

- In the absence of a comprehensive governance structure around the areas of LRM, the biggest challenge will be aligning the roles and responsibilities of the management with the regulatory requirements. The roles and responsibilities of the Board of Directors, Risk Management Committee, Asset Liability Committee (ALCO) and Asset Liability Management (ALM) Group have to be properly aligned and documented in the policies.
- Setting up of liquidity risk tolerance limits is the most crucial area which has to be articulated in both quantitative and qualitative terms as a part of the risk appetite statement. Also, board oversight of LRM should be expanded and it should be ensured that the board has a broad understanding of LRM concepts as well as sufficient knowledge of the underlying technical details.

Funding strategy and monitoring concentration

NBFCs should establish a funding strategy with effective diversification in terms of sources and tenor. There should be no over-reliance on a single source. Hence, concentration in sources of funds should be monitored in a regular fashion.

- The NBFC sector is dependent on low-cost short-term funding and for non-deposit taking NBFCs there is heavy reliance on bank and market borrowings. If supply from these two sources dries up, problems may arise. Hence, the strategy should be well planned and approved by the board, with details on limits.
- In terms of monitoring, the amount of funds raised from each source can be represented as a percentage of total funding to provide a true picture of the funding mix and any concentration (that may arise) to the senior management, alerting them to take any necessary action. Another way of representing funding concentration is considering the stock of the top 20 large deposits as a percentage of total deposits and the top 10 borrowings as a percentage of total borrowings.



Maturity profiling and tolerance limits

The first bucket (1–30 days) will now be broken down into three parts: 1–7 days, 8–14 days and 15–30 days. Also, the net cumulative negative mismatches in the 'Statement of Structural Liquidity' should not exceed 10%, 10% and 20% of the cumulative cash outflows in the maturity buckets of 1–7 days, 8–14 days and 15–30 days respectively.
A similar change in buckets will take place in the 'Interest Rate Risk Report'.

- NBFCs will face greater challenges in setting up prudential limits on cumulative mismatches across time buckets that go beyond 30 days and up to 1 year. The tricky part is that in the case of commercial banks, the portfolios are more or less spread across multiple sectors, whereas in the case of NBFCs, the fundamental business model focuses on specific sectors. For example, a housing finance company will have assets with an average maturity of more than 15 years in contrast to someone in the consumer finance business with an average maturity of assets even less than 1 year. Therefore, it is imperative to consider the nature of business in setting up internal prudential gap limits.

Liquidity coverage ratio (LCR)

LCR will be applicable for all deposit-taking NBFCs and non-deposit taking NBFCs with an asset size of INR 5,000 crore and above. To adhere to the same, NBFCs have to maintain a stock of high-quality liquid assets (HQLA) worth at least 100% of the total net cash outflows over the next 30 calendar days. This will be implemented in a calibrated manner over a period of five years from 1 April 2020 to 1 April 2024.

- Currently, NBFCs are heavily reliant on commercial papers and other short-term funding avenues. This is a step by the regulator to end this reliance and gradually bring in changes in the asset liability mix. It would increase banks' confidence, who have become reluctant to lend to NBFCs.
- However, LCR may decrease the pace of credit build-up for NBFCs. The requirement to set aside at least 60% of HQLA (which would comprise cash and sovereign securities) would initially dry up a sufficient amount of cash which would otherwise have been available for lending. The other aspect is that mandatory investments in government securities mean that NBFCs will have to replace some high-yielding loans with government securities which offer significantly lower yields. This will in turn hurt their margins.

Stock approach

NBFCs will have to monitor liquidity risk based on the 'stock approach' that essentially measures comparable positions of different parameters at a particular point.

- NBFCs have to decide on suitable indicators/ ratios pertaining to liquidity risk and then set predefined internal limits upon board approval. The desired levels can be decided based on their significance to the business of the NBFC as well as industry averages—for example, regulatory ratios like commercial papers as a percentage of total public funds, total liabilities and total assets, non-convertible debentures (NCDs; original maturity less than one year) to total assets.

Liquidity risk MIS and dashboards

NBFCs have to develop a reliable MIS to provide timely and adequate information on the liquidity position of the institution both under normal and stress situations.

- Institutions with immediate access to all pertinent liquidity risk information shall be in a better position to manage their liquidity profile more effectively. However, currently, there are some gaps in terms of the required infrastructure to monitor liquidity at the level of sophistication the regulator wants. Reliance on multiple spreadsheets and time-consuming processes is a widespread phenomenon. To solve these issues, an MIS can be set up in the form of a liquidity dashboard to get an overall view of the liquidity position on a day-to-day basis.
- The challenge will be to develop liquidity dashboards which are capable of extracting accurate data at the desired level of quality and granularity in a readily available fashion. However, the dashboards will bring in benefits like enhanced reporting capabilities, analytical exercises and stress testing.

Contingency funding plan (CFP)

NBFCs should ensure that a suitable contingency funding plan is in place in order to cope with a severe liquidity crunch which may curtail their ability to do business at large.

- The recent turmoil in the debt market has made it evident that in case of liquidity contingencies, NBFCs have to incur higher borrowing costs, which brings their profits down. Having a CFP would enable NBFCs to manage borrowing/lending activities in a timely and cost-efficient manner. This would involve designing suitable approaches to raise funds in case contingencies arise. NBFCs will have to document trigger points, sets of activities, approval matrices, escalation matrices, levels of haircut (in case of asset sale), etc., along with details of each of the alternative approaches.

Stress testing

Stress tests should be conducted periodically for a set of short-term scenarios comprising institution-specific, general market and combined scenarios. Also, NBFCs have to develop mechanisms to survive the minimum stress period.

- It is a good practice to make stress testing an integral part of the overall liquidity risk management culture in financial institutions, including NBFCs. The challenge for the NBFCs will be developing institution-specific, general market and combined scenarios on their own, in the absence of regulatory scenarios. They will have to identify potential sources of a liquidity crunch and analyse the possible impact of future events on cash flows, liquidity position and profitability. While designing the scenarios, the nature of business, day-to-day activities and sensitive areas should also be factored in.
- For survival strategies for the minimum stress period, the tenor will be different for the institution-specific and general market scenarios.

Intra-group transfers

NBFCs have to develop LRM processes and funding options that are consistent with the complexity, risk profile, and scope of operations of the group. While developing such processes, they need to recognise the likely increased risk arising due to intra-group transactions and exposures (ITEs).

- To develop comprehensive processes around the area of intra-group transfers, NBFCs have to review the intra-group lending policies and assess their compliance with the regulatory guidelines.
- Also, it has to be verified if the legal, operational and regulatory limits have been considered for transferability within and across the business entities and currencies. NBFCs have to make sure that transfers to the subsidiaries are done at an arm's length basis by comparing the rates with market rates.

Other significant areas

Apart from the key areas mentioned above where detailed coverage is necessary, there are a few more aspects to look into. They have been summarised below.

- Asset diversification strategies are necessary both in terms of maturity profile as well as sector to maintain a healthier liquidity position and comfortable level of LCR.
- NBFCs have to develop liquidity risk monitoring tools in terms of availability of unencumbered assets as well as market-related monitoring tools. For example, in the case of a listed entity, monitoring the price to book ratio or the coupon at which long-term and short-term debts are being raised by them will help to identify risks early.
- The framework should also include management of liquidity risks relating to certain off-balance sheet exposures on account of SPVs, derivatives, etc.
- Public disclosure templates have to be developed in a prudent manner and the correct reporting processes have to be developed.
- Sound internal controls are necessary to make sure the right set of actions are taken at the right time and all liquidity risk events are mitigated proactively.

Summing up

NBFCs will have to constantly evolve over time to ensure they have a sound LRM framework in place. To begin with, they will have to review their portfolio composition and build in a stock of HQLA gradually to meet the regulatory guidelines. They may face margin pressure in the short to medium term. However, in the long run, the benefits derived out of the strong LRM framework will outweigh the cost.

Medium and small NBFCs will need to put in significant efforts to develop and implement the overall framework in an effective manner. It will help them manage their liquidity risk in an organised fashion and make it an integral part of business decisions.

On the other hand, for larger NBFCs, most of the liquidity risk monitoring capabilities are already in place and the focus should be on strengthening their governance structure. The two key challenges for the board and Risk Management Committees with regard to effective governance are owning the indications on liquidity risk and effectively utilising them for strategic decision making.

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